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SUBJECT: EL SALVADOR SEEKS DEBT RESTRUCTURING LOAN, NEW TAX REVENUES

REF: A. 06 SAN SALVADOR 2351
¶B. 07 SAN SALVADOR 1185
¶C. 07 SAN SALVADOR 2431
¶D. 07 SAN SALVADOR 2383

¶1. (SBU) SUMMARY. According to a senior Ministry of Finance official, the Government of El Salvador (GOES) is privately pursuing $1.2 billion in new World Bank loans to restructure existing debt, prevent a fiscal crisis in 2011, and free new money for social spending. The Ministry of Finance is also struggling to make up budget shortfalls of over $100 million caused by commodity price-driven subsidies. New taxes and government austerity measures are expected to raise $65-70 million, while the budget deficit is expected to increase by 0.4-0.5% of GDP. Separately, the state-owned hydroelectric authority is exploring issuing new debt to cover a projected $100 million shortfall caused by its electricity subsidies. The economic pressures are weighing heavily on the incumbent, pro-U.S. ARENA government that is trying hard to get reelected but sometimes loses its way in the process. END SUMMARY.

DEBT RESTRUCTURING

¶2. (SBU) On July 14, Manuel Rosales, Advisor to the Minister of Finance, told Econoff that the Government of El Salvador (GOES) hopes to pursue $1.2 billion in loans from the World Bank to restructure its existing debts. (NOTE. El Salvador faces a potential fiscal crisis in 2011, when an approximately $650 million Eurobond comes due.)

¶3. (SBU) The GOES has been privately negotiating with the World Bank, after previous approaches to the Inter-American Development Bank (IDB) and the Central American Bank for Economic Integration (CABEI) did not provide adequate debt relief. El Salvador would receive two tranches of loans - $550 million to be used to pay off existing, higher interest debt from the IDB and other sources, and $650 million to pay off the 2011 Eurobond. Minister of Finance Handal was briefing President Saca on the proposal the morning of July 14, and Hacienda will not discuss the proposal publicly until they get the go-ahead from President Saca.

¶4. (SBU) Rosales said the World Bank offered 30-year loans at LIBOR plus 5 basis points. The loans include a 5-10 year grace period and an initial commission of 0.25%, with no additional commissions. Rosales estimated that the GOES would save $75 million per year in 2009 and 2010 in debt service payments, money which could be used to finance new social programs. Overall, the World Bank loans would smooth El Salvador's debt payments into a gradual, declining curve. Under the current situation, El Salvador faces three massive spikes from 2011, 2025, and 2036 Eurobonds.

¶5. (SBU) World Bank staff told Rosales that the leftist opposition FMLN had approached the Bank earlier this year, during Presidential Candidate Mauricio Funes's visit to Washington, to talk about debt issues. (NOTE: ARENA Presidential Candidate Rodrigo Avila is scheduled to meet with the World Bank during his July 16-18 visit to Washington. END NOTE.) Rosales stated that the World Bank would initially approach the FMLN deputies about the proposal, and it could be presented to the Assembly in mid-August. In Rosales' view, the FMLN is "so confident that it will win the (March 2009) election" that it would vote for the proposal to ensure a strong fiscal position for its government. (NOTE. New debt issuance requires a super-majority -- 2/3 approval -- vote in the Assembly. The FMLN has opposed any new debt for the last two years, and some of its votes are needed to obtain that super-majority. END NOTE.)

¶6. (SBU) Rosales "had been burned by the FMLN before" on debt issues, however, so the Ministry would continue to plan for alternatives. If the Assembly should fail to approve this new loan, Rosales stated that the 2011 fiscal situation was not as dire as some, such as Citibank, had forecast. According to his projections, El Salvador should run a $100 million surplus in the 2010 budget and a $150 million surplus in the 2011 budget, so the next government would only need to come up with $400 million to cover the 2011 Eurobond debt. Should no new debt be issued, he speculated, the most likely solution was a trust, similar to what had been established for the government pension fund (reftel A), and for other government expenditures such as education and security (reftel B).

BUDGET PROBLEMS: SUBSIDIES REQUIRE NEW REVENUE
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¶7. (SBU) According to Rosales, tax receipts have been growing better than expected in 2008, but not fast enough to meet budget projections. Conversely, a few policy changes have contributed to a drop in revenues. First, the GOES had created new income tax deductions for health and education expenses, which caused the bulk of the decline. Second, to combat higher oil prices, the 1% tariff on oil imports had been cut to zero. (NOTE. However, in a move criticized by everyone except those receiving the subsidy, the GOES did impose a $0.10 per gallon tax on gasoline to pay for bus transportation company subsidies and is about to grant them another subsidy. Reftel C. END NOTE.) Finally, after the bread bakers' protest earlier in the year, the import duties on wheat and flour had been cut from 10% to zero.

¶8. (SBU) Rosales expected tax revenues to decline later in the year, however, as higher energy and food prices drive more consumers to shop in the informal economy, where value-added taxes (VAT) are seldom collected. The tax authorities were stepping up enforcement, but the informal sector is large and disperse enough where this would have minimal effect. Rosales also noted that revenues from the $0.20 per gallon gasoline tax, which goes to a dedicated fund for roads, was already down 6% for the year, as gasoline consumption has declined due to the high prices.

¶9. (SBU) At the same time, Rosales said energy and commodity prices were driving up the cost of government subsidies. At $140 per barrel for oil, the GOES' propane gas subsidy would cost an estimated $175 million. Rosales said that the 2008 budget had used an International Monetary Fund (IMF) estimate of $70 per barrel. Similarly, the electricity subsidy for families who use less than 99 kilowatts per month will cost at least $60 million at current prices. Separately, the state-owned Hydroelectric Executive Commission of Rio Lempa (CEL), requires at least an additional $100 million to meet its energy subsidy obligations (reftel D). Overall, Rosales projected that El Salvador would run a deficit of 2.3%-2.4% of GDP for 2007, up from the budget projection of 1.9%.

¶10. (SBU) The Ministry of Hacienda (Finance) was looking to make up the budget shortfall through a series of new measures. First, the minister had instructed the Directors of Taxation and Customs to develop an plan to increase collection (Rosales had no specifics). Second, President Saca had ordered all ministries to adopt an austerity program, which Rosales estimated would save $15 million. Third, the Assembly had approved a tax "amnesty," where penalties and interest for non-payment would be waived. Rosales said the previous amnesty was successful, and they expected at least $25 million in new tax payments from this one. (NOTE. The GOES last offered an amnesty in 2004, shortly before the 2005 Presidential election. END NOTE.) Finally, Rosales estimated that a $0.04 tax on telephone calls originating outside El Salvador, which has passed the Assembly but not yet entered into force, would raise $25-30 million, which would directly fund the electricity subsidy. According to the draft law, the new telephone tax is to fund new social programs.

¶11. (SBU) Rosales said CEL was seeking loans to cover its $100 million shortfall. CEL was applying for a $40 million loan from Central American Bank for Economic Integration (CABEI), and the state-owned Multisector Investment Bank (BMI) is investigating an international bond offering to raise the other $60 million. Rosales did not specify whether the GOES would seek legislative approval for this new debt or establish a new trust.

COMMENT

¶12. (SBU) El Salvador faces many financial pressures: rising rates of inflation (9% in the first six months of the year versus 4.7% in 2007), slower remittance growth (about 6% versus double digit growth in previous years), and no short term end in sight to high food and fuel prices. Its escalating subsidy costs combined with a slowdown in the economy (reduced growth projections from 5% to 3.5-4% growth) and more movement into the informal sector and concomitant reductions in fiscal revenue also spell trouble for the incumbent ARENA administration.

¶13. (SBU) El Salvador has elections in January and March
¶2009. We will have a better indication of where the FMLN stands when it releases its fiscal and economic plan in mid-to-late August. Though they have indicated a renewed willingness to consider multilateral financial institution loans, the FMLN's commitment to new loans is by no means assured. Several prominent macroeconomists have described the 2011 debt crisis as a "political problem," not an economic one, but unless the two parties are able to reach some accommodation, it will have serious economic consequences for the country.

¶14. (SBU) ARENA's steadfast refusal to target or reduce subsidies forces it to look for additional funds to pay for them, with the tax on incoming long distance calls only the latest example. This short-sighted approach hurts El Salvador's long-term competitiveness and business climate, and the GOES risks complaints filed against it under CAFTA-DR. In their preoccupation to get ARENA re-elected, the Saca administration is laying aside some of the good economic policies that helped ARENA get elected the previous four times.
GLAZER